No. 12456

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ESTATE OF R. L. LANGER, Deceased, ELEANORE LANGER, Executrix; ELEANORE LANGER; C. ABBOTT LINDSEY, and PAULINE LINDSEY,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

REPLY BRIEF FOR PETITIONERS.

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REPLY BRIEF FOR PETITIONERS.

I.

The Statute Involved Must Be Construed so as to Effectuate Its Objectives.

Respondent, citing *Smart v. Commissioner,* 152 F. 2d 333 (C. C. A. 2d, 1945), argues that:

> "In effect, the statute provides an exemption and is, therefore, subject to strict scrutiny."

The opinion in the *Smart* case, which involved Sec. 107 (a) of the Internal Revenue Code, contains the following statement by Judge Learned Hand (152 F. 2d at page 335):

> "On the other hand, the section is an exemption and as such must submit to close scrutiny."

With due respect to the Court of Appeals for the Second Circuit, it is believed that the characterization of the section as an exemption is incorrect. The exemption provisions of the Internal Revenue Code permit particular taxpayers, or particular types of income, to escape income taxation. No such privilege is granted by Sec. 107. None of the petitioners' income here under consideration has escaped tax. The entire amounts are includible, and have been included, in their gross income. Therefore, there has been no exemption of this income from taxation. Sec. 107 simply specifies a *rate* of tax, and a method of computation, different from that prescribed for normal purposes.

Petitioners contend that because it is a remedial provision, Sec. 107(d) must be so construed as to afford the relief intended by Congress. Petitioners recognize that in order to receive the benefits of the section they must bring themselves within its scope. This, it is respectfully submitted, they have done. But exemption of income from the burden of taxation is not an issue in this case.

II.

The Circumstances Were Unusual; and the Deferment Was Not a Voluntary Act.

Respondent makes the rather astounding argument (Resp. Br. p. 8) that petitioners had untrammeled freedom of choice because they failed to assert their freedom. Specifically, the argument is that:

> "Not only was the freedom of choice with taxpayers in their conduct of the corporation's affairs, but theirs remained the freedom because of their omission to abuse it."

The mere statement of the proposition answers it. It could as well be argued that the innocent victim of armed robbery voluntarily surrenders his watch and his wallet because of his failure to resist the encroachment upon his liberty and accept the probable violent consequences.

At page 9 of his brief, respondent refers to the 1941 modification of the loan agreement, in which there was contained a definition of net income out of which contingent payments to Pacific were to be made. The provision permitted the corporation to deduct operating expenses, including management expenses. The reason for inserting such a provision was that, in the absence of some definition of net income, dispute might arise as to the extent of the corporation's liability for the contingent payments required by the 1941 modification. If any inference can fairly be drawn from said provision, it would seem to be that there was, immediately prior thereto, some restraint upon salary payments.

Finally, respondent argues that this is the *usual* case of a corporation which in bad times defers payment of executive salaries. For this Court to accept that proposition, it would not only have to conclude that insolvency is a usual characteristic of business operations, but also that while in receivership or bankruptcy a corporation usually fails to pay any executive salaries whatever. It is believed that neither of said conclusions would be sound.

Conclusion.

For the foregoing reasons, as well as those stated in petitioners' opening brief, the decisions of the Tax Court should be reversed.

Respectfully submitted,

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May 1, 1950.